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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matters of	)	
	)	
Access Charge Reform	)	**CC Docket No. 96-262**
	)	
Price Cap Performance Review for Local Exchange Carriers	)	**CC Docket No. 94-1**
	)	
Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers	)	**CCB/CPD File No. 98-63**
	)	
Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA	)	**CC Docket No. 98-157**
	)	

MCI WORLDCOM COMMENTS ON PETITIONS FOR RECONSIDERATION

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MCI WORLDCOM COMMENTS ON PETITIONS FOR RECONSIDERATION

I. Introduction and Summary

MCI WorldCom, Inc. (MCI WorldCom) hereby submits its comments on petitions for reconsideration of the Fifth Report and Order.[1]

The Commission should deny Bell Atlantic and GTE's request to reinstate the low end adjustment for LECs electing pricing flexibility. Their argument that elimination of the low end adjustment raises Fifth Amendment issues has no merit, because neither LEC has submitted any evidence that the regulatory scheme applicable

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[1]In the Matter of Access Charge Reform, Fifth Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 96-262, released August 27, 1999 (Fifth Report and Order).

to price cap LECs electing pricing flexibility would impair the price cap LECs' financial integrity.

The Commission should grant the request of Network Access Solutions that the Commission increase the Phase I pricing flexibility threshold. The Phase I test adopted in the Fifth Report and Order would grant pricing flexibility on all routes in an MSA even though there would be no sunk investment by competitors on the vast majority of these routes.

II. The Commission Should Deny Bell Atlantic and GTE's Request to Reinstate the Low End Adjustment for LECs Electing Pricing Flexibility

Bell Atlantic and GTE request that the Commission reconsider the requirement that price cap LECs obtaining pricing flexibility forego the use of the low end adjustment mecahnism. They argue that elimination of the low end adjustment mechanism violates the Fifth Amendment because it "could prevent a price cap company from having the opportunity to earn a reasonable rate of return on its investments."[2] They also argue that the Commission's concerns about cost-shifting do not justify elimination of the low end adjustment mechanisms. Neither of the LEC arguments has any merit.[3]

[2]GTE Petition at 4.

[3]MCI WorldCom's discussion of the low end adjustment mechanism is in the context of conditions established by the Commission as part of the Fifth Report and Order's pricing flexibility framework only. Further, MCI WorldCom's comments regarding the Commission's decision to eliminate the low end adjustment mechanism as a condition for obtaining the pricing flexibility authorized by the Fifth Report and Order should not be seen as an endorsement of the Fifth Report and Order's pricing flexibility

A. There is No Unconstitutional Taking

Parties challenging a rate order on constitutional grounds bear the "heavy burden of making a convincing showing that [the FCC's policy] is invalid because it is unjust and unreasonable in its consequences."[4] The Commission can easily reject Bell Atlantic and GTE's constitutional arguments because neither LEC has submitted any evidence that the rates permitted under the price cap rules, absent the low-end adjustment, would affect the price cap LECs' financial integrity and prevent them from raising capital, or fail to compensate the price cap LECs with returns on investment commensurate with other enterprises having corresponding risks.[5]

There is no reason to believe that elimination of the low-end adjustment would impair a price cap LEC's financial integrity. The low-end adjustment mechanism is, after all, merely a "backstop" mechanism.[6] Under price cap regulation, it is the price cap mechanism itself that has primary responsibility for ensuring that rates remain with the "zone of reasonableness." By setting the initial price cap rates at just and reasonable levels, and then adjusting rates annually to reflect inflation and changes in LEC

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framework. MCI WorldCom has petitioned the D.C. Circuit Court of Appeals for review of the Fifth Report and Order.

[4]Illinois Bell v. FCC, 988 F.2d 1254, 1261 (D.C. Cir. 1990) (citing FPC v. Hope Natural Gas, 320 U.S. 591, 602).

[5]See Southwestern Bell Telephone Company: Tariff F.C.C. No. 73, Memorandum Opinion and Order on Reconsideration, 13 FCC Rcd 6964, 6970 (1998) (citing Illinois Bell v. FCC, 988 F.2d at 1260).

[6]Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786, 6802-6804 (1990).

productivity, price cap regulation seeks to ensure that all subsequent rates are just and reasonable as well. The price cap LECs are further protected by the Commission's ongoing monitoring of their earnings and by the periodic price cap performance reviews.

LEC earnings since 1990 confirm that there is no risk that the price cap mechanism could force LEC rates down to confiscatory levels. As the LECs are fond of pointing out when they are campaigning for the elimination of accounting rules, the low-end adjustment mechanism has rarely been used. RBOCs have only used the low-end adjustment mechanism only twice.[7] Similarly, GTE would hardly have been at risk if the low-end adjustment mechanism had not been available. In fact, the low end adjustment mechanism has served mainly to pad GTE's coffers -- because GTE files separate tariffs for each study area, it has been able to claim a low-end adjustment for some study areas even as its overall earnings approached 20 percent.[8]

In the extremely unlikely event that the price cap mechanism and the price cap performance reviews do not maintain rates that are just and reasonable for a particular LEC, the Commission's regulatory scheme makes specific provision for above-cap tariff filings. In the context of these above-cap filings, the LECs are given the opportunity to provide information sufficient to establish that the increase is needed if the LEC is to

[7]Trends in Telephone Service, September 17, 1999, Table 15.1 (NYNEX reported rates of return of 8.54 percent for New England Telephone and 9.82 percent for New York Telephone in 1991, and SWBT reported a rate of return of 9.91 percent in 1998).

[8]In 1998, GTE claimed a low end adjustment in five small study areas (COKY, COAL, GTMN, GNCA, and GTAR), even as it was earning over 20 percent in 26 study areas. See Trends in Telephone Service, September 17, 1999, Table 15.1.

have an opportunity to attract capital.[9] Bell Atlantic and GTE's complaint that the review standards imposed on these filings are unduly burdensome is without merit; the cost support specified in the rules is required if the Commission is to be able to evaluate whether a rate increase is necessary.

That the regulatory scheme applicable to LECs electing pricing flexibility raises no constitutional concerns is confirmed by the fact that this regulatory scheme would, for all intents and purposes, be the same as the one used to regulate AT&T for several years. The AT&T price cap plan did not incorporate a low-end adjustment mechanism, and relied almost exclusively on the price cap mechanism itself to maintain rates within the "zone of reasonableness." The AT&T price cap plan also provided for above-cap filings; the standards for evaluating these above-cap filings were the same as those that would apply to a price cap LEC above-cap filing.

B. The Commission's Decision to Eliminate the Low End Adjustment for LECs Electing Pricing Flexibility was Correct

GTE suggests that there was no reason for the Commission to eliminate the low-end adjustment for LECs electing pricing flexibility, contending that the Commission did not need to be concerned that price cap LECs would overallocate costs to price-cap regulated services. GTE argues that "it is difficult to understand why a carrier would

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[9] LEC Price Cap Order, 5 FCC Rcd at 6823 ¶ 304.

behave in such a manner in order to earn what the Commission has defined as an unattractive rate of return."[10]

It is irrelevant whether the low-end adjustment mark represents an "attractive" or "unattractive" rate of return. As the Commission has recognized in many other proceedings, rate of return regulation creates incentives for carriers to shift costs to regulated services.[11] The incentive is somewhat attenuated for LECs subject to price cap regulation, but these LECs can still increase their revenues by shifting sufficient costs to price-cap regulated services to trigger the low-end adjustment mechanism. As the Commission has recognized, such cost shifting would harm customers of price-cap regulated services and allow the LECs to cross-subsidize their more-competitive ventures.[12]

As the Commission correctly recognized, pricing flexibility will increase the risk of cost misallocations; as more services are removed from price cap regulation, the reported rate of return becomes more sensitive to the LEC's allocation of costs between more competitive and price-cap regulated services.[13] And, it would be particularly inappropriate to permit a LEC benefiting from pricing flexibility to profit from cost misallocations. As the Commission correctly concludes, "an incumbent LEC seeking

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[10]GTE Petition at 10.

[11]Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order, 2 FCC Rcd 1298 (1987).

[12]Id.

[13]Fifth Report and Order at ¶163.

pricing flexibility to compete more vigorously in the marketplace should not be afforded any rate-of-return-based protection from any risk associated with its competitive ventures."[14]

Bell Atlantic suggests that, rather than eliminate the low-end adjustment mechanism entirely, the Commission could have addressed the risks of cost misallocations by specifying cost allocation rules.[15] While cost allocation rules can provide a useful safeguard in a variety of contexts, the Commission was correct to decide against creating a complex cost-allocation mechanism solely to preserve the low-end adjustment. The low-end adjustment mechanism is merely a secondary "backstop."

C. LECs Electing Pricing Flexibility Should Forego Use of the Low-End Adjustment Mechanism at the Holding Company Level

GTE suggests that the Commission should, "at the very least," rewrite Section 69.731 so that the rule does not require a LEC to give up the low-end adjustment on a holding-company-wide basis once it obtains pricing flexibility in one of its study areas. GTE argues that "there is little, if any, opportunity for a carrier to shift costs between study areas to permit it to . . . trigger the low-end adjustment mechanism."[16]

Contrary to GTE's claim, there is substantial opportunity for companies to shift costs between study areas. While, as GTE points out, LECs usually record plant-specific

[14]Fifth Report and Order at ¶ 165.

[15]Bell Atlantic Petition at 15.

[16]GTE Petition at 9.

costs on a study area basis, other types of costs, such as overhead costs, must be allocated among study areas because these costs are incurred at the operating company or holding company level.

Given that LECs have the opportunity to shift costs among study areas, the Commission's decision to eliminate the low-end adjustment mechanism at the holding company level was correct. If a LEC had access to the low-end adjustment mechanism in some study areas but not in others, the LEC would have a clear incentive to overallocate overhead costs to those study areas where it had access to the low-end adjustment mechanism.

III. The Commission Should Revise the Pricing Flexibility "Triggers"

Network Access Solutions Corporation (NAS) requests that the Commission reconsider the "Phase I" pricing flexibility trigger, which permits ILECs to offer contract tariffs if they can show that competitors have collocated in 15 percent of an MSA's central offices. NAS argues that the Commission has offered no rational explanation for its choice of the 15 percent threshold, and requests that the Commission modify the rule by increasing the threshold level.

According to the Commission, the Phase I test is supposed to permit the LECs to respond to competition while also "prevent[ing] exclusionary pricing behavior."[17] The premise of the Fifth Report and Order is that the likelihood of successful predation

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[17] Fifth Report and Order at ¶79.

decreases to the extent of "sunk investment" by new entrants,[18] and that "collocation is a reliable indication of sunk investment by competitors."[19]

Assuming arguendo that the "sunk investment" standard for determining when pricing flexibility is warranted is reasonable,[20] the Phase I trigger adopted in the Fifth Report and Order is plainly inadequate because it permits pricing flexibility when the vast majority of markets in an MSA have no sunk investment by competitors.

A. The Commission Has Not Provided a Rational Explanation for its Choice of the Phase I Threshold

MCI WorldCom agrees with NAS that the Commission has failed to provide a rational explanation of its choice of the 15 percent trigger. The Commission has, in particular, failed to explain why competitors' collocation of transmission facilities in 15 percent of wire centers represents sufficient sunk investment by competitors to prevent exclusionary pricing behavior by incumbent LECs.

Rather than perform an analysis of the level of sunk investment necessary to prevent exclusionary pricing behavior, the Commission appears to have arrived at the 15 percent threshold by taking the 25 percent threshold proposed by Bell Atlantic and then

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[18]Fifth Report and Order at ¶80.

[19]Fifth Report and Order at ¶81.

[20]MCI WorldCom's references to the "sunk investment" standard and the collocation-based test should not be seen as an endorsement of this standard or this test. MCI WorldCom's discussion of the NAS petition for reconsideration refers to the "sunk investment" standard and collocation-based test only to demonstrate that the Fifth Report and Order's Phase I thresholds do not even satisfy the standard established by the Commission.

adjusting it for differences between the collocation-based test adopted by the Commission and the broader test proposed by Bell Atlantic.[21] The obvious problem with this approach is that the Commission never explains why Bell Atlantic's proposed 25 percent threshold was a reasonable starting point. In particular, the Commission never explains why a 25 percent threshold, in conjunction with Bell Atlantic's proposed test, would correspond to sufficient sunk investment to deter exclusionary pricing by the incumbent LEC. In fact, Bell Atlantic never justified its proposed 25 percent threshold on "sunk investment" grounds or on the basis of any other economic theory. In all probability, Bell Atlantic proposed its test and the 25 percent threshold simply because it thought it could meet this threshold in most MSAs in its service area.[22]

The Commission attempts to support its choice of the 15 percent threshold by citing some CLEC fiber deployment data for MSAs where competitors have collocated in 15 percent of the wire centers.[23] The Commission suggests that this fiber deployment data shows that collocation in 15 percent of wire centers correlates with a "significant" investment in competitive facilities. But the fact that the 15 percent collocation threshold correlates to a level of fiber deployment that is "significant" in absolute terms is irrelevant. The Commission fails to explain why this level of fiber deployment represents sufficient "sunk investment" by competitors to meet the Commission's

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[21]Fifth Report and Order at ¶ 95.

[22]See maps attached to Bell Atlantic's April 27, 1998 *ex parte* presentation. Letter from Kenneth Rust, Bell Atlantic, to Magalie R. Salas, FCC, April 27, 1998.

[23]Fifth Report and Order at ¶ 95.

objective of preventing exclusionary pricing behavior by the incumbent LECs. Indeed, as discussed in more detail below, it is apparent that this level of fiber deployment is not sufficient to deter exclusionary pricing behavior.

B. The Commission Should Use a Higher Threshold for the Phase I Test

According to Commission precedent, each point-to-point special access or switched transport route in an MSA constitutes a separate geographic "market."[24] The Commission should reconsider the Fifth Report and Order because the Phase I test's 15 percent threshold would allow the incumbent LECs to engage in exclusionary pricing in the vast majority of markets in an MSA.

The Fifth Report and Order relies on "sunk investment" by competitors to prevent ILECs from using exclusionary pricing practices to deter entry into a market. However, the Phase I threshold adopted by the Commission allows the LECs to offer contract prices in all markets in an MSA, even when the vast majority of these markets have no sunk investments by competitors. For example, a price cap LEC could meet the 15 percent Phase I threshold, and offer contract prices for switched transport services between an IXC POP and all end offices in an MSA, even if there were no sunk investments by competitors on 85 percent of the routes from the POP to the end offices in that MSA.

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[24]See, e.g., In the Matter of COMSAT Corporation, Order and Notice of Proposed Rulemaking, 13 FCC Rcd 14083, 14100 (1998).

The markets in which competitors have made no sunk investments would represent a significant portion of the total revenues in the MSA. After all, a price cap LEC can meet the Phase I test even if the wire centers with collocation represent only 30 percent of the LEC's entrance facility and interoffice revenues.[25] In fact, the Section 69.725 revenue attribution rule allows LECs to meet the Phase I test even if the revenues addressable by competitive facilities represent less than 30 percent of the total MSA revenues. By counting half of the revenues of an interoffice circuit as addressable even when there is a collocation at only one end of the circuit, the Section 69.725 revenue attribution rule substantially overstates the revenues that are addressable.[26] It is almost guaranteed that the LECs will be able to meet the 30 percent revenue threshold in every MSA, even in those MSAs where the only competition is for entrance facility routes to a few central offices.

The Commission suggests that a collocation-based test paints a conservative picture of sunk investment by competitors, noting that it does not take into account competitive transmission facilities that completely bypass the LEC network.[27] But even

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[25]Fifth Report and Order at ¶ 98.

[26]As a simple example, consider an MSA with four central offices. Suppose there is competitive transport from an IXC POP to only one of the four central offices, and assume that this entrance facility route represents 25% of the total of entrance facility and interoffice revenues. Under Section 69.725, the LEC would be given credit for the entrance facility revenues that are addressable (25% of the total entrance facility and interoffice revenues) and one-half of the interoffice revenues (i.e., one-half of 75% of the total, or 37.5%). Thus, the LEC could claim that competitors have collocated in offices representing 62.5 percent of revenues (25% + 37.5%), even though only 25% of the revenues are actually addressable by competitive facilities.

[27]Fifth Report and Order at ¶ 95.

if complete bypass were taken into account, it is doubtful that a significant number of markets would have sunk investment by competitors. In fact, the Fifth Report and Order implicitly assumes that, even if complete bypass were taken into account, no more than 25 percent of the wire centers would have sunk investment by competitors at the Phase I threshold.[28] In other words, the Commission designed the Phase I test to give price cap LECs pricing flexibility in all markets in the MSA even if 75 percent of the wire centers in the MSA had no sunk investment by competitors at all.

Similarly, the CLEC fiber deployment data cited by the Commission does not provide any evidence that the Phase I threshold corresponds to sunk investment by competitors in a significant number of markets. The Commission does not put the fiber deployment data into context by comparing CLEC and ILEC fiber miles in MSAs that meet the Phase I threshold. Had the Commission performed this comparison, it would have found that the CLEC fiber route mileage was much less than the ILEC fiber route mileage.[29] This would have confirmed that, at the Phase I threshold level, most markets in an MSA would have no sunk investment by competitors.

Given that the Commission is relying on sunk investment by competitors to deter predatory pricing, but the Phase I test would allow contract pricing when the vast majority of markets in an MSA have no sunk investment by competitors, it is apparent

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[28]Id. (The 15 percent threshold was selected to be comparable to Bell Atlantic's proposed test, which would have required price cap LECs to demonstrate that competitors either had collocations or fiber in 25 percent of wire centers.)

[29]In their comments on the RBOC forbearance petitions, several parties presented evidence showing that ILEC fiber miles far exceeded CLEC fiber miles. See, e.g., AT&T Opposition at 7, CC Docket No. 99-24.

that the Commission has set the Phase I threshold too low. While the Commission may be correct that administrative convenience justifies a Phase I test that grants contract pricing authority before every wire center has a competitive facilities,[30] there is no justification for granting contract pricing authority when the vast majority of markets in an MSA, representing well over 70 percent of the MSA's transport and special access revenues (other than channel terminations), have no sunk investments by competitors and are therefore vulnerable to predatory pricing.

If the Commission maintains the "sunk investment" standard and the collocation-based test, the Commission should, at a minimum, grant the NAS petition for reconsideration of the Phase I triggers, and revise the Phase I thresholds to a level sufficient to ensure that most markets in the MSA are not vulnerable to predatory pricing by the incumbent LEC.

NAS's proposal for separate high-capacity and low-capacity pricing flexibility triggers has considerable merit, particularly for end user channel terminations in Phase II. It is very likely that the Phase II test for channel terminations established by the Fifth Report and Order could be met at a stage in the development of the market when whatever competition there is for channel termination circuits is only for high-capacity, DS3 and above circuits. Competition for lower-capacity circuits is likely to develop much more slowly, given that these circuits do not carry traffic between points of high traffic concentration.[31] Consequently, the LECs are likely to obtain Phase II pricing

[30] Fifth Report and Order at ¶ 83.

[31] Fifth Report and Order at ¶ 80.

flexibility while they still possess significant market power in the market for DS1 channel terminations. The Commission should impose a significantly stiffer test for Phase II pricing flexibility for DS1 channel terminations, in order to protect consumers of incumbent LEC special access circuits and to protect competitors that rely on incumbent LEC DS1 channel terminations to reach their customers. As the Commission has recognized, higher thresholds are warranted when competitors still rely on incumbent LEC facilities to reach the end user.[32]

IV. Conclusion

For the reasons stated herein, the Commission should grant the Network Access Solutions petition for reconsideration and deny the Bell Atlantic and GTE petitions for reconsideration.

Respectfully submitted,
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[32] Fifth Report and Order at ¶ 80.

STATEMENT OF VERIFICATION

I have read the foregoing, and to the best of my knowledge, information, and belief there is good ground to support it, and that it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on December 1, 1999.

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CERTIFICATE OF SERVICE

I, Vivian I. Lee, do hereby certify that copies of the foregoing Comments were sent via first class mail, postage paid, to the following on this 1st day of December, 1999.

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